BIG VISION, BOLD ACTION

The mission of the Climate Protection Campaign is to create a positive future for our children and all life by inspiring action in response to the climate crisis. We advance practical, science-based solutions for significant greenhouse gas reductions.

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June 8, 2007

Winston Hickox, Chair
Dr. Lawrence Goulder, Vice Chair
AB32 Market Advisory Committee
C/o California Environmental Protection Agency
And California Climate Action Team
1001 I Street, 15th Floor
Sacramento, CA 95818
climatechange@calepa.ca.gov

Re: Comments on the Market Advisory Committee Draft Report

Dear Mr. Hickox and Market Advisory Committee members,

Please accept the following comments on the MAC Draft Report.

The Draft Report contains many important ideas for the Air Resources Board to consider in designing a cap and trade system. Market mechanisms are very complex, and economic theories about them are still evolving. We commend the Market Advisory Committee for taking on this task and for attempting to find consensus and providing a readable document that will be useful to the Air Resources Board.

In the Climate Protection Campaign's previously submitted comments, we advocated for:

1) An upstream system
2) 100% auction of permits
3) Compensating consumers on a per capita basis

We understand there was some diversity in opinion among Committee members on many design elements. Nevertheless, we were pleased with the Draft Report's favorable comments towards the first two of those recommendations. The third recommendation is barely mentioned.

We encourage the Committee to:

- Discuss additional benefits of Program 4 (the upstream system), and Option B (implementing an upstream system all-at-once) which we strongly support.

- Add a section on consumer compensation to the Final Report. This could go under "Uses for Revenue from an Auction" or in a new section for "Specific recommendations to address environmental justice concerns."
- Following the Committee's desire to include transportation, we suggest removing Option 1, which does not include transportation, from further consideration
- Remove the sentence on page 52 that declares no environmental difference between allocation methods. Auctioning is the environmentally superior allocation method.
- Limit offsets, and require performance standards for offsets that are allowed.
- Ask the State to adopt a cap-and-trade system by 2010, instead of 2012.
- Review the Background Materials we have submitted for more information.

The following is a discussion of specifics from the Report:

1) An upstream system

Starting on page 27, the Report describes several programs which provides different levels of coverage. Programs 1, 2, and 3 are downstream systems. Program 4 is upstream.

Programs 3 and 4 are the most comprehensive. Would Program 3 cause double counting? In other words, would some firms be charged twice for the same emissions? Program 4 has the simplest administration (Program 4 has only 50 facilities versus 490 facilities in Program 3), while also providing maximum coverage.

At the bottom of page 32, the report states that according to economic theory the distribution of cost impact is the same for Programs 3 and 4, both upstream and downstream. This statement must be questioned. Administrative costs to 490 firms would be higher than the costs to just 50 firms. All of those costs would be passed on to consumers. Additionally, CARB, or the enforcing agency would require more staff and resources to administer a program to 490 firms than to just 50 firms. Therefore, the tax burden or percent of auction revenues that go to administrating the system would be greater. From a consumer perspective, there is a large difference between the costs. Choosing a more complex system when a simpler system that accomplishes the same result is available would violate the Market Advisory Committee's Guiding Principles.

Starting on page 34, the Report discusses whether to include the transportation sector. We are pleased to see that the Committee prefers to include transportation. Considering how central transportation is to California's emissions profile, that it is the fastest growing sector, and that the ETS's failure to include transportation was one of it's major mistakes, we feel that **it is vital to include transportation**. We hope that this will remove Option 1, which does not include transportation, from further consideration.

On page 36, the Report considers two options: Option A which is a gradually increasing downstream system, or option B which is an upstream system. **We strongly advocate**

for Option B. This is California's opportunity to show leadership. Downstream programs have had major problems. An upstream system in California could be a template for a future national or international program. It would show that California has learned from mistakes of previous systems, rather than repeating them. We believe that others would surely follow California's leadership.

The left column of the following table is from page 36. The right column is our responses:

Report's stated reasons for Option A (phased-in downstream system)	**Reasons against Option A or for Option B**
-- the ability to begin the program in the very near future with implementation of the first step (Program 1)	CARB would be faced with multiple rule-making processes.
-- the flexibility associated with a more gradual expansion of the cap-and-trade program's scope	Flexibility? Or moving target?
-- greater prior experience with the downstream regulatory approach—experience that reduces risk and can help lower administrative costs	Would this make up for the fact that you have to regulate 490 facilities (instead of just 50 with an upstream system)?
-- the fact that downstream entities—the entities that may have the most options for reducing emissions—are the ones required to submit allowances for compliance	An upstream system would provide a price signal to those facilities.
-- a larger number of regulated entities, which may promote greater liquidity in the allowance market	Our goal is to reduce emissions, not to provide more liquidity to the market. There are many ways to provide liquidity, including linkage with other upstream systems.
-- no need for special provisions to reward facilities that engage in carbon capture and sequestration	This needs more explanation.

2) 100% auction of permits

We are very pleased that the Draft Report mentions auctioning allowances, and describes it as a reasonable option in market design. Page 45 provides a good discussion of the benefits of auctioning.

On page 52, the Report states that, "under no circumstances does allowance distribution affect the achievement of the (emission reduction) targets themselves." We believe this to be false. Setting aside economic theory and its assumption of perfect information, the empirical evidence shows, in the case of RECLAIM and the ETS, that the method of distribution (grandfathering) led to overallocation, which led to few emission reductions. More emissions reductions would have been achieved if fewer allowances had been distributed, and if the companies had a price signal instead of a handout. Some observers might think overallocation was only due to lack of correct information. But they are ignoring the different incentives to businesses in self-reporting emissions under a grandfathered versus an auction system. RECLAIM and the ETS are two circumstances where allowance distribution affected the achievement of the (emission reduction) targets. Additionally, as the Report states, investments from revenues from an auction can provide additional emissions reductions. **Auctioning is the environmentally superior allocation method.**

On page 52, the Report lists principles for distributing allowances. The following table compares an auction of allowances with a giveaway:

Principles for Allowance Distribution	**Auction**	**Giveaway**
• reduces the cost of the program to consumers, especially low-income consumers	Yes	No
• avoids windfall profits where such profits could occur	Yes	Needs safeguards
• promotes investment in low-GHG technologies and fuels (including energy efficiency)	Yes	Yes
• advances the state's broader environmental goals by ensuring that environmental benefits accrue to overburdened communities	Yes	Needs safeguards
• mitigates economic dislocation caused by competition from firms in uncapped jurisdictions	Raises revenues to do this	Unclear
• avoids perverse incentives that discourage or penalize investments in low-GHG technologies and fuels (including energy efficiency)	Yes	Assumes windfall profits would be invested, not just returned to shareholders
• provides transition assistance to displaced workers	Raises revenues to do this	No
• helps to ensure market liquidity	Unclear	Yes, (through overallocation and at the expense of emission reductions which is the purpose of the program).

We appreciate the Report's discussion of the windfall profits problem of the ETS on page 97, and the reasoning behind the RGGI's auction decision on page 98. We hope that California can learn from the innovations of RGGI. Auctioning permits can lessen the costs of the program, and overall costs to society.

We also appreciate the Report's mention of positive outcomes that can be achieved through the use of revenues raised by an auction. On page 12, the Report states that, "California could use a portion of revenues raised by an auction.." to "…provide direct environmental justice benefits."

The Report also correctly acknowledges the incentive for early action by auctioning. On page 57, the Report states, "If allowances are auctioned, early action may provide its own rewards by reducing the number of allowances a firm must purchase once the cap-and-trade program is in place."

We understand the Committee's suggestion of a "learning period" following the ETS model, and hesitation since previous GHG cap and trade systems did not auction. However, the RGGI will be auctioning, and the ETS recognizes that its failure to auction was a major mistake. During the learning period, every permit that would be given away for free is money taken from consumer's pockets. We are concerned that a learning period featuring a giveaway of allowances could turn into an entrenched system. We believe that California can confidently proceed directly to a 100% auctioned system.

3) Compensating consumers on a per capita basis

The Climate Protection Campaign has advocated for compensation of consumers as part of a cap and trade system. The reason for this is that increased fuel or electricity costs will be passed on to consumers.[1] In our previous comments, we describe two methods to compensate consumers: a cash dividend from revenues raised by an auction, and a Share representing an allowance allocated directly to consumers. We request the Committee include additional information on consumer compensation in the Final Report.

The report lacks specific recommendations when it comes to environmental justice concerns. Consumer compensation on a per capita basis is a specific way to address environmental justice concerns, if it is done on a per capita basis. Four methods of consumer compensation are: 1) using revenues from an auction of allowances for a cash dividend to consumers (the Sky Trust model similar to the Alaska Permanent Fund), 2) a tax break (such as the Earned Income Tax Credit), 3) an earmarked credit (such as a coupon for Energy Star appliances, transit passes, or hybrid cars), or 4) distributing a share to consumers representing the emissions (which could be sold to regulated companies in a private market)[2]. Each of those options has benefits. We acknowledge that there is much to discuss before such a system could be adopted by the ARB. The MAC report would be a good place to begin that discussion.

The Report implies consumer compensation at least twice. At the bottom of page 55, the Report mentions "direct allocation to households." At the bottom of page 51, the Report mentions, "direct consumer rebates." Unfortunately, when the Report describes potential uses of allowance value (or revenues from an auction), it fails to mention consumer compensation. The Report mentions funding of mechanisms to counter consumer impacts, but lacks specifics. This omission can be corrected in the Final Report.

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[1] Congressional Budget Office "Trade-Offs in Allocating Allowances for CO2 Emissions" http://www.carbonshare.org/docs/CBOCap_Trade4-07.pdf
[2] www.carbonshare.org

Other issues:

We agree with the Report that **performance standards for offsets** are necessary. One offset category in the Agriculture sector could be biodigesters at dairies. The Straus Family Creamery in Marin County has a biodigester which is an example of a project that reduces greenhouse gas emissions from cows, provides renewable energy, and can provide an additional revenue source for the dairy industry. However, we disagree with the Committee members who feel that CDM credits are acceptable for California. The CDM lacks the necessary accountability, and there are horror stories about Chinese factories selling millions of dollars of CDM credits and using proceeds to fund coal fires power plants. **Offsets should be limited.**

Regarding the electricity sector, we agree that a generator-based system might be appropriate at the national level, but not for California. It seems that the PUC has decided a load-based system is preferable. A first-seller system may have legal problems.

We applaud the Report for denying the need for a safety valve, on page 63. The Committee should be commended for this. An additional issues which was not discussed is the possible need for a price floor for permits. The floor would ensure that emissions will carry a minimum price signal, regardless of particular market conditions. Another approach would be to empower an organization such as a Trust act as the "Carbon Fed" to intervene in the system according to specified rules as necessary. Such safeguards are insurance against uncertainties in a new market.

Regarding linkage to other systems, the Report is correct when it notes that linking to other systems that provide coverage differently is problematic (page 34). However, this is not a reason for California to choose a downstream system or a grandfathered allocation. If California wisely chooses an upstream system with an auction, then we believe that the ETS will follow suit and allow for linkage in a future period. Additionally, linkage would not be feasible with systems that use a grandfathered allocation. Linking with grandfathered systems would put California businesses at a disadvantage, and provide additional benefits to foreign companies that already have windfall profits. California's inclusion of consumer compensation could provide a model for other systems to address justice concerns.

Finally, we ask the Committee to consider asking the State to adopt a cap-and-trade system as we have suggested by 2010, instead of 2012.

Thank you for your consideration.

Sincerely,

Mike Sandler
Carbon Share Project Manager

Ann Hancock
Executive Director